

September 16, 2011

MEMORANDUM

TO: Senator John Arthur Smith, Chairman and LFC Members

FROM: Charles Kasscieh, Economist

SUBJECT: LFC Report of Investment Performance – FY11 Fourth Quarter

INVESTMENT PERFORMANCE HIGHLIGHTS:

- Percentage gains are slowing as the bull market loses steam. Including investment returns, contributions and distributions, the state's aggregate fund value showed no gains in the last quarter. The total value of the funds is currently \$36.3 billion up roughly \$5.6 billion from June 30, 2010.
- All funds achieved one-year results above the 60 percent equity/40 percent fixed income indices of 19.6%. Relatively high asset allocation in equities has helped reward the pension and investment funds over the last 12 months. ERB is the only one to have outperformed its benchmark.
- This apparent underperformance might be misleading, as the internal benchmark reflects a very high allocation to domestic equity, an asset class that has done particularly well. The current target does not reflect SIC's intent to reduce the policy allocation to domestic equities. Thus, until the policy target has been officially adjusted, any comparison to the policy index return will be over-stated.
- All asset classes for all funds had mixed returns for the one quarter period. However for the one year period, for economically targeted investments (ETIs) in the Severance Tax Permanent Fund (STPF). Best active management for SIC included private equity and credit strategies as they recover value.
- ERB remains the only fund to beat both the 60/40 index and internal benchmarks for the quarter, one-year and five-year periods. ERB has returned 5.3% per annum over the last 5 years, tops amongst all the New Mexico funds.

- Peer rankings were mixed, with ERB improved on the one-quarter and five-year performance while the one year dropped due to a lower June return compared to its peers. PERA remained in the 99th percentile for the five year period, while it made huge improvements in the one-year performance versus its peers.
- Both permanent funds ranked in the top decile in the second and third quarters, however for the final quarter for FY11 the permanent funds dropped with respect to their peers for the one quarter period. Their five-year standings have improved since the second quarter.

FUND ASSET VALUES

Although losing steam from impressive quarterly returns seen in the first quarters of the fiscal year, the fourth quarter still produced gains that continue to help restore fund balances devastated by the 2008-2009 market collapse. Aggregate fund value totaled \$36.3 billion as of June 30, 2011, up \$5.6 billion from a year ago, or over 18 percent. Including contributions and distributions as well as investment returns, ERB saw an increase of \$47 million, compared with \$263 million for the quarter ending March and \$400 million for the second quarter of FY11. With these gains, ERB is at \$9.5 billion which is not far from the September 2007 high of \$9.6 billion. PERA, which increased total assets by just over \$1.9 billion over the last 12 months, is also inching its way toward its high of \$13.5 billion. The SIC funds (Land Grant Permanent Fund and Severance Tax Permanent Fund) distributed \$763 million during the 12-month period, primarily to New Mexico's educational institutions. Even with this cash outflow, favorable market conditions have added \$2.4 billion to the permanent funds over the same period.

Current Asset Values* (millions)
For Quarter and Year Ending June 30, 2011

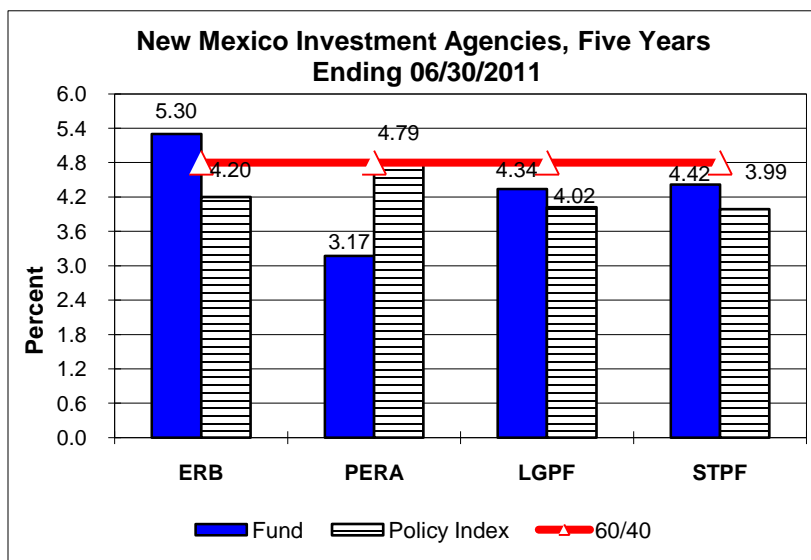
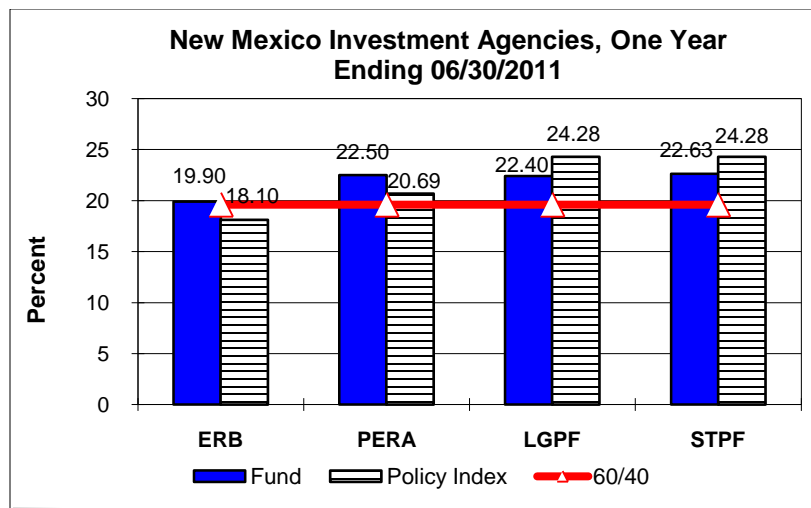
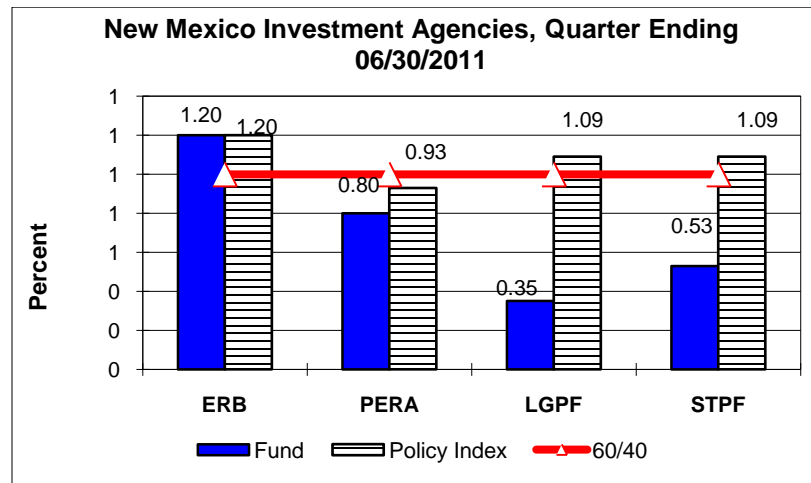
	ERB	PERA	LGPF	STPF	TOTAL
Current Asset Value	\$9,513	\$12,134	\$10,688	\$3,940	\$36,277
Value Change - Quarter	\$47	-\$55	\$6	-\$12	-\$14
Percent Change - Quarter	1.2%	.8%	.35%	.53%	-.1%
Value Change - Year	\$1,334	\$1,920	\$1,842	\$573	\$5,669
Percent Change - Year	19.9%	22.5%	22.4%	22.63%	18.5%

*Changes include investment returns, contributions and distributions.

PERFORMANCE SUMMARY

Quarter returns for all funds ranged from 0.35 percent for LGPF to the high of 1.2 percent for ERB. ERB had a better performance for the quarter, the year, and the five year period than the 60/40 index, a hypothetical portfolio of 60 percent stocks and 40 percent fixed income that represents a passive, traditional asset portfolio. PERA, STPF, and LGPF all outperformed the 60/40 index for the one year period, however all three failed to outperform the 60/40 index in the quarter and five year periods. Produced during more normal market conditions, the 60/40 index continues to support the state's diversification into alternative asset classes initiated in 2005 by the enactment of the Prudent Investor Act.

All funds except ERB suffered compared to the 60/40 index for the five-year period, which included the 2008-2009 market collapse that rewarded funds holding high allocations in U.S. Treasuries. Significant contribution from a tactical allocation to credit strategies in the last quarter of FY09 lifts ERB's five-year return.



Performance vs. Internal Benchmarks. Comparing each fund to its internal benchmark yields additional insight into how well the agencies are managing the funds. The ERB fund posted the highest gains for the quarter meeting its policy index returns, and it continues to outperform its benchmarks for both the one-year and the five-year periods. For the permanent funds as well as PERA, all three underperformed their benchmarks for the last quarter. The LGPF and STPF were mixed in the five-year period with LGPF outperforming the policy index by 32 basis points (bs)¹ and the STPF lagging by 43 bps. This apparent underperformance of SIC funds might be overstated, as the internal benchmark reflects a very high allocation to domestic equity, an asset class that has done particularly well. SIC has reduced their exposure to this asset class, as most institutional funds have done, in response to the exceptional volatility experienced during the market turmoil of 2008-2009. Until the policy target has been officially adjusted to reflect this intent, the policy index return may be over-stated.

PERFORMANCE RELATIVE TO PEERS

Comparing performance to peers can shed insight into how policy decisions impact short and long term results. Consistent underperformance relative to peers suggests a failure to execute modern portfolio management effectively as well as the inability to hire good managers. This quarter produced relatively similar peer rankings for all of the New Mexico funds. ERB made improvements in the one-quarter and five-year rankings. Most notably, ERB has remained in the top quartile for the five-year period compared to its peers. PERA improved its one-year comparison, but PERA funds remained in the 99th percentile for the five year period. PERA remains stuck in the bottom 10 percent for the five-year comparison, still unable to overcome impacts from poor past manager underperformance that contributed to the fund's decline of \$4.2 billion during FY08-FY09. The permanent funds maintained their high yearly rankings with the STPF improving from the 26th to the 16th percentile and the LGPF remaining at the 17th percentile. The permanent funds did not fare well in the one-quarter rankings. In the previous quarter both LGPF and STPF were in the top decile, but have fallen to the bottom half of rankings in the fourth quarter

Peer Percentile Rankings*

	QTR	1 Year	5 Year	10 Year
ERB	59	81	22	62
PERA	90	32	99	87
LGPF	91	17	63	68
STPF	86	16	81	79

* Percentile rankings (1 is highest) for ERB and PERA relative to U.S. Public Funds.
Permanent Funds ranked relative to U.S. Endowment Funds.

ACTUAL VS. TARGET ASSET ALLOCATIONS

The target asset allocations shown below represent each fund's plan structure. Attachment A provides detail on how each asset class contributed to the funds' overall return as well as compared to benchmarks. Fiscal year 2011 saw a bull market, and the funds were all able to take advantage of their overweight positions in equities early in the year. The funds have begun to

¹ One basis point equals 0.01 percent.

take a more risk adverse approach which has their asset allocation for equities near their targets. The funds have also begun to hold larger amounts of cash to continue to lower their exposure to risk.

Fund Asset Allocation Detail, Quarter Ending June 30, 2011

	ERB*		PERA*		LGPF*		STPF*	
	Actual	Target**	Actual	Target**	Actual	Target	Actual	Target
US Equity	24.5%	25.0%	28.4%	27.0%	41.7%	51.0%	39.3%	48.0%
International Equity	15.7%	20.0%	26.1%	27.0%	14.4%	10.0%	14.3%	10.0%
Fixed Income	30.5%	33.0%	25.8%	26.0%	21.9%	15.0%	24.5%	11.0%
Total Alternatives	23.3%	17.0%	19.1%	20.0%	20.8%	24.0%	21.6%	31.0%
Private Equity	4.2%	2.0%	3.1%	3.5%	9.3%	6.0%	13.3%	12.0%
Real Estate/Real Assets	6.5%	5.0%	6.8%	6.0%	3.4%	3.0%	4.9%	3.0%
Absolute Return	7.0%	10.0%	9.3%	10.5%	6.1%	15.0%	3.4%	15.0%
Other								
Global Asset Allocation	5.6%	5.0%						
ETI***							0.0%	1.0%
Cash Equivalents	6.1%	0.0%	0.8%	0.0%	1.2%	0.0%	0.3%	0.0%
Total Fund %	100%	100%	100%	100%	100%	100%	100%	100%

*All funds are reducing exposure to equities and increasing other asset allocations.

**Due to the long implementation period for some alternatives, both PERA and ERB have adopted interim targets.

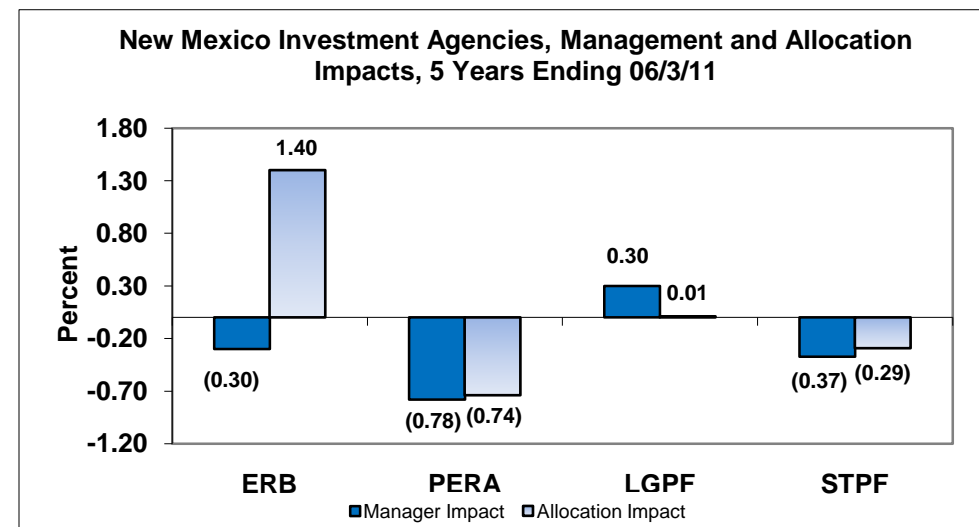
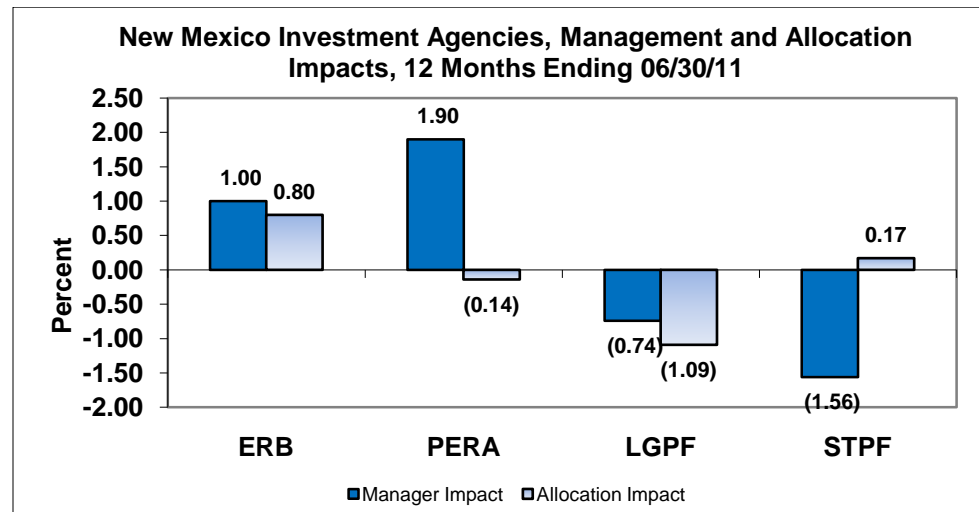
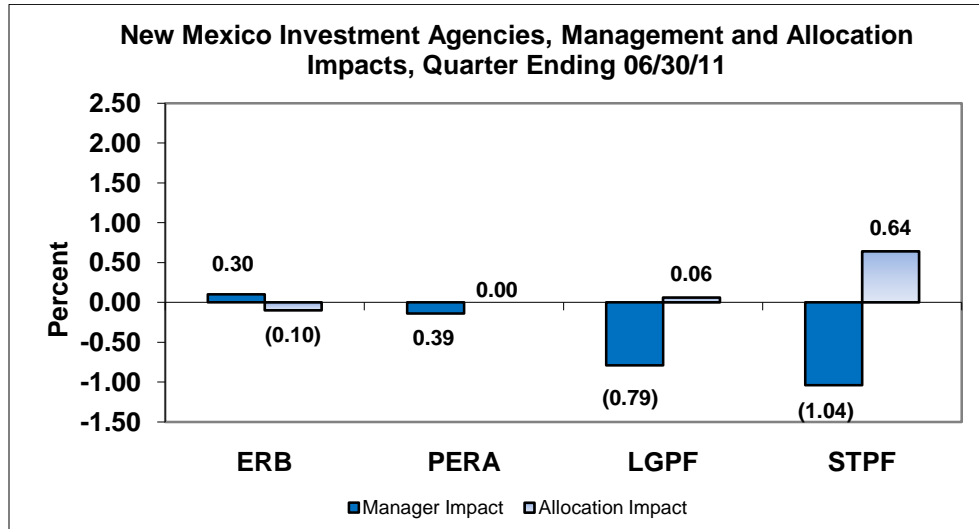
***ETI: Economically targeted investments include state private equity.

ATTRIBUTION ANALYSIS

Performance relative to fund benchmarks can be further broken down into specific contributors to results.

Policy Impact. How plan structure, or asset allocation, impacts performance can be measured by comparing the fund's policy index to the median fund's performance. ERB was able to outperform their policy index in each of the three time periods. PERA, LGPF, and STPF all underperformed the policy index in the one quarter performance, but fared better in the one-year and five-year. As would be expected, SIC funds' higher relative allocation to domestic equities during this bullish run helped add 166 bps of performance to the LGPF for the one year period.

Active Management Impact. Indexed assets will move as the market moves while active management is aimed at producing a higher return based on the manager's skill at taking advantage of market inefficiencies. Overall, active management was muted for the quarter but remains strong for the pension plans' 12-month period. Lackluster active management in some asset classes continues to plague SIC, although the agency notes that it has been firing underperforming managers since April 2010.



Allocation Impact. Allocation impact reflects how deviating from the target asset allocations either adds or detracts from performance. Deviations can occur due to market conditions moving the asset value—which may trigger rebalancing the class to within the targeted range—or through tactical decisions made by the boards. As discussed, much of the allocation impact for the quarter and trailing 12 months is explained by over- and under-weighting domestic equities. This detractor for SIC is slightly offset by the fixed income allocation impact of 20 bps for the year, the only positive impact for the portfolio. ERB’s reporting of allocation impact is particularly robust in all periods. PERA’s quarterly over-performance of 121 bps for domestic equities was undercut by a -76 bps allocation impact associated with underweighting fixed income. PERA started taking a more defensive position in this asset class with expectations of a rise in inflation, which has yet to materialize in any material fashion. On its part, ERB’s defensive position reflects a desire to diversify portfolio risk and minimize return volatility by reducing exposure to equities.

LONG TERM PERFORMANCE SUMMARY

Despite strong investment gains for FY10 and FY11, longer term returns remain below newly set targets of 7.75 percent for the pension plans and 8 percent for the permanent funds needed to fund obligations.

Fund Performance vs. Benchmarks

Educational Retirement Board (ERB)

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
19.90%	18.10%	81	5.30%	4.20%	22	5.80%	5.50%	45
Median Fund Performance 14.00%			Median Fund Performance 4.30%			Median Fund Performance 5.80%		

Public Employees Retirement Association (PERA)

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
22.50%	20.69%	32	3.17%	4.79%	99	5.63%	5.60%	80
Median Fund Performance 13.93%			Median Fund Performance 4.47%			Median Fund Performance 6.22%		

Land Grant Permanent Fund (LGPf)

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
22.40%	24.28%	17	4.34%	4.02%	63	5.40%	5.20%	68
Median Fund Performance 12.40%			Median Fund Performance 4.50%			Median Fund Performance 6.20%		

Severance Tax Permanent Fund (STPF)

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
22.63%	24.28%	16	4.42%	3.99%	81	4.60%	5.30%	79
Median Fund Performance 12.40%			Median Fund Performance 4.50%			Median Fund Performance 6.20%		